

# CALIFORNIA STATE TEACHERS' RETIREMENT SYSTEM

## BILL ANALYSIS

---

### **Senate Bill 766**

**Senator Florez (As amended 5/13/03)**

### **Position:**

**Sponsor (Staff Recommendation)**

### **Proponents:**

**Berman, DeValerio, Pease Tabacco, Burt & Pucillo (Sponsor),  
Consumer Attorneys of CA**

### **Opponents:**

**CA Chamber of Commerce, CA Manufacturer's and  
Technology Assoc., TechNet, American Electronics Assoc.,  
American Insurance Assoc., numerous accounting firms and  
insurance companies**

## **SUMMARY**

Senate Bill 766 allows public retirement systems and other eligible entities to hold liable anyone who knowingly or intentionally makes a false statement to induce another to buy or sell a security.

## **HISTORY**

P.L. 105-353, the Securities Litigation Uniform Standards Act of 1998 (SLUSA) among other things, requires that most class action lawsuits involving more than 50 people be brought in federal court. It also allows public pension plans the right to proceed in state court only in cases still allowed under state law.

P.L. 104-67, the Private Securities Litigation Reform Act of 1995 (PRLSA) among other things, provides safe harbor to certain individuals for forward-looking statements regarding a security's projected performance or operations if the statement is immaterial or accompanied by certain cautions. It also requires the plaintiff to prove that the person made the statement with either actual knowledge of its false or misleading nature, or the statement was approved by an executive officer.

Chapter 88, Statutes of 1968 (AB 1—Knox) makes unlawful specified acts that create a false or misleading appearance in connection with securities transactions and provides a civil remedy for the willful participation in any of these acts.

## **CURRENT PRACTICE**

Recent changes in federal law prevent, in most circumstances, private class actions for securities fraud from being brought under state law. However, an exception was made to allow public retirement systems like the California State Teachers' Retirement System (CalSTRS) to join

together to file suit in state court under the Corporate Securities Law of 1968. Besides individual investors, public retirement systems are the only other parties provided access to state court under the Corporations Code to recover losses sustained by fraud of this type. Other investors are forced to seek recovery for fraudulent acts under the California Civil Code.

In the past, public retirement systems have used these provisions to recover losses due to a company's or individual's fraud or manipulation of the securities markets. Specifically, state law prohibits making a false or misleading statement to induce another to buy or sell a security (Corporations Code Section 25400) and allows the injured party to seek damages (Corporations Code Section 25500).

In late 2001, two decisions by separate State Court of Appeals narrowed the application of these statutes, which have been allowed to stand by the State Supreme Court. The first, *Kamen v. Lindly*, 94 Cal. App. 4<sup>th</sup> 197, limited the definition of individuals who could be held liable under Section 25400 for any false or misleading statement to those directly participating in the market through the purchase or sale of a particular security. In the second, *California Amplifier v. RLI Insurance Co.*, 94 Cal. App. 4<sup>th</sup> 102, the court ruled that liability for damages under Section 25500 is limited to persons who willfully participate in a violation of Section 25400. This increased the level of culpability required before damages can be assessed.

Since a willful violation of the law cannot be insured, the court's ruling in *California Amplifier* essentially voids insurance coverage for corporations and corporate officials when such lawsuits are filed. This denies CalSTRS and other public retirement systems the ability to recover losses from corporate officer's and director's insurance policies – perhaps the corporation's last remaining source of funds available for any judgment or settlement.

## **DISCUSSION**

Senate Bill 766:

- Makes various findings by the Legislature concerning recent court decisions relating to securities fraud.
- Declares the Legislature's intent to abrogate those court decisions.
- Specifies that a person is not required to be a market participant for purposes of liability for securities fraud under state civil law.
- Specifies that the changes this bill makes to existing law may apply to cases filed on and after January 1, 2004.

According to the bill's sponsor, its purpose is to reverse these two courts of appeal decisions and restore to public pension plans and other eligible investors the ability to name all parties that

participate in the fraud as defendants and to restore the availability of insurance to both protect companies as well as provide resources for aggrieved investors to recover.

Although SB 766 would overturn the court's ruling in *Amplifier* that a person must knowingly and intentionally make a false statement in order to meet the "reckless conduct" standard to be held liable for a violation of Corporations Code Section 25400, it does not specify what the appropriate mental state should be. According to the Senate Judiciary Committee analysis: "Supporters argue that the California *Amplifier* decision was wrongly decided because it holds aiders and abettors to a higher standard of liability than primary violators...accounting firms that ignore obvious irregularities in a corporation's finances or investment banks that ignore evidence of problems with a corporation generally do not meet the willful participation requirement...these parties should be held to the same standard (recklessness) as the parties that actually make the false statement." It further goes on to cite opponents who believe these rulings protect innocent third parties from frivolous lawsuits and that making non-market participants subject to the same standard exposes the business community to additional, often frivolous litigation and will discourage companies from sharing information with investors.

In its letter to Senator Florez opposing this measure, the California Chamber of Commerce stated: "Enabling claims to be brought against persons who are not 'market participants' for acts that are not intentional could potentially stifle investment in California, deprive corporations and their shareholders of competent and honest directors, chill statements made by the press and tie the hands of accountancy professions in making evaluations of corporate fiscal conditions." In addition, opponents believe that by effectively expanding the scope of insurance policies for corporate officials, insurers will eventually increase premiums or stop issuing these policies altogether.

It is apparent that alleged and actual misconduct at corporations such as Enron, Worldcom, Adelphia, Global Crossing, Quest, Tyco, and now HealthSouth is confirming that financial market and government regulators did not, in previous years, adequately discourage corporate misconduct. Furthermore, the settlements government officials and regulators have made with these corporations and market participants have not adequately compensated investors like CalSTRS for the losses it sustained as revelations about the misconduct drove the price of these securities down and/or forced these companies into bankruptcy. CalSTRS has been able to recover losses from such malfeasance by participating in securities litigation in federal court, both as part of a class action and as lead plaintiff. The \$28 million in settlements CalSTRS has recovered as a result of this litigation has directly benefited the Teachers' Retirement Fund.

SB 766 will restore the right of California Public Pension Systems to name all parties that participated in the fraud as defendants in a state court action, including accounting firms, investment banks and corporate officials otherwise provided safe harbor, and also restore the availability of insurance to protect companies, providing financial resources for aggrieved investors to recover.

## **FISCAL IMPACT**

Benefit Program Costs – The performance of the investment portfolio affects CalSTRS' ability to fund the benefits for its membership. CalSTRS' expanded ability to recover investment losses caused by malfeasant market participants as a result of this measure may increase the amount of money available for benefits.

Administrative Costs – Costs associated with filing suit against malfeasant market participants will be paid from funds recovered through these lawsuits.

## **RECOMMENDATION**

Sponsor. This measure increases the ability of CalSTRS to recover on behalf of its members, monetary losses to the Teachers' Retirement Fund suffered as a result of fraud and deception by corporations and corporate officials.